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## Best investment or best headlines?

At the beginning of each year investors are accustomed to reading reflective reports on “top gainers” or “best performers”. These articles like to highlight some of the star funds, stellar stocks, and hot investments from the previous 12 months, and the prescient analysts who predicted them. Investors tend to associate top gainers with the best way to make money, which on the face of it is a natural conclusion. But dig a little deeper and some interesting facts show that is often a wrong assumption.

Investors may have understood that Asian funds were the top gainers last year, since Asia-related investment funds made up “four out of the top five performing funds in Singapore last year” – seeing huge gains of up to 36 per cent. This may come as a surprise to many investors, when anyone acting on Asia recommendations at the beginning of last year would have seen an average drop of around 16% for Asian equities as a whole. Here’s a table showing the falls of major indices for 2002.

MSCI Pacific (SGD)	-15.9%
STI	-17.5%
Dow (SGD)	-22.3%
S&P500 (SGD)	-28.5%
NASDAQ (SGD)	-36.4%

### Falls of broad indices in 2002

Even if your definition of Asia includes emerging markets and excludes Japan (represented by the MSCI AC Far East Free Ex Japan), your loss for 2002 was the about the same – 16.4% in SGD terms. Although Asian funds fell, they were still the best performers right? That depends. Investors don't uniformly invest on Jan 1 of each year, so unless you did that, the news-making gains of 2002 are not what you experience.

For example, the average loss for 2002 on locally registered Korea funds was just under 14% (excluding sales charges). But someone investing in May 2002 could have lost close to 30% by year-end (perceptively or coincidentally, in April last year I warned clients that a “glance at the progress of the stocks on the Korea Stock Exchange makes one ‘think bubble’”).

Here’s another way of looking at the indices, but this time taking the average of \$1,000 “invested” at each week during the year. Or in other words this looks at the average profit of 52 investors, each investing in a different week across the year.

MSCI Pacific (SGD)	\$888.21
Dow (SGD)	\$886.09
S&P500 (SGD)	\$870.92
NASDAQ (SGD)	\$867.44
STI	\$858.04

### Average result of \$1,000 invested across 2002

Using this measure Asia still looks good, but interestingly the local stock market fell to last place. And the blue chip Dow Jones was about equal to Asia. What about someone who heard a tip in April to go into a particular sector? Here’s the same table for a May investment.

Dow (SGD)	\$794.29
S&P500 (SGD)	\$781.47
STI	\$778.62
NASDAQ (SGD)	\$776.51
MSCI Pacific (SGD)	\$767.51

**April tips: \$1,000 invested in May 2002**

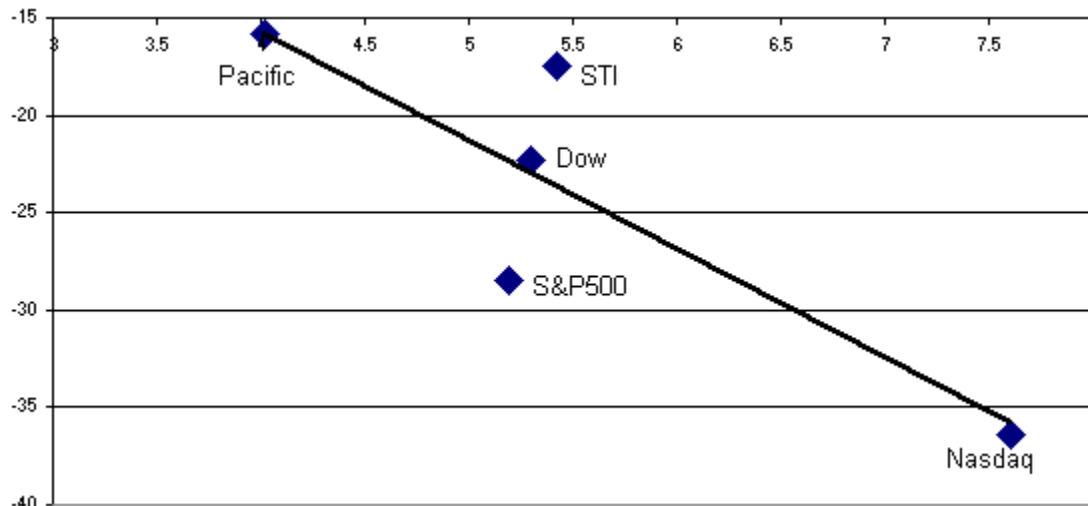
Using this measure Asia now drops into last place and the Dow Jones takes the lead. This just goes to show that over a short period, good returns from smaller, more volatile markets depend largely on good timing. Anyone buying during a temporary peak could lose badly.

But don't returns need to be seen in the context of volatility? Yes, a highly volatile investment may be performing well superficially, but extremely badly on a risk-adjusted basis. Here's a table showing the ranking using a one-year Sharpe ratio (a measure of how good a portfolio is taking into account risk; the higher the Sharpe ratio, the better the portfolio or fund's historical risk-adjusted performance).

STI	-0.316
MSCI Pacific (SGD)	-0.386
Dow (SGD)	-0.416
NASDAQ (SGD)	-0.503
S&P500 (SGD)	-0.553

**Sharpe ratio**

This is really surprising as our homegrown STI comes out top, and is largely a theoretical glitch – a consequence of all indices posting negative returns. The same result doesn't look so obvious when seen in the risk-return chart.



**Return v Volatility**

So what's the conclusion? The best investment depends a lot on your starting point and the way "best" is defined. Certainly, if you had relied on an analyst call you would have been severely burnt if you'd invested in Asia in the middle of last year. No doubt some narrow funds did better than the broad indices, especially in small Asian markets. If you had picked out a good Indonesian fund in Jan 1 and sold in June, you would have made an eye-popping 90%. But if you'd picked the same fund in May and sold at year-end, you would have *lost* 24%. How many people like to take those kinds of bets?

If market timing is a lottery, should you just pick the best funds by their star ranking? A study by finance professor Matthew Morey of Pace University casts doubts on that too. Morey found that funds with high ratings from agencies like Morningstar Inc. and Value Line tend to get largest sales. But Morey found that as a group, star fund performance is just average.

Fund Categories	Four and Five Stars	One, Two, and Three Stars	Un-rated
Equity	\$79.6	-\$108.2	\$38.8
Fixed Income	\$64.6	\$28.8	\$19.4
Total	\$144.2	-\$79.4	\$58.2

**Chasing stars: flows into US funds**

US\$ billions. Source: Financial Research Corp. 2002 data through Nov. 30.

Simply put: investors want ratings and analysts to predict future performance – a miracle nobody can deliver. In fact, the best investment is a good mix of diversified assets. It's the same every year, but it's just not interesting reading.

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